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IN THE

Supreme Court of the United States

October Term, 1965

NO. 547

WILLOW TERRACE DEVELOPMENT CO., INC., and
POST OAK MANOR BUILDING CO., INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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COMMISSIONER [redacted] INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE 5th CIRCUIT

OPINION BELOW

The opinion of the Tax Court of the United States entered on June 28, 1963 (R. 453-482) is reported at 40 TC 689. The opinions of the United States Court of Appeals for the Fifth Circuit entered on June 1, 1965 (Appendix A, infra, pp. 17-30), and on July 1, 1965 (Appendix B, infra, pp. 31-32), are not officially reported.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on June 1, 1965 (Appendix A, infra, pp. 29-30). The judgment of the United States Court of Appeal for the Fifth Circuit denying rehearing was entered on July 1, 1965 (Appendix B, infra, p. 31). The jurisdiction of the Court is invoked under 28 USCA 1254 (1) and 28 USCA 2101 (c).

QUESTION PRESENTED

Whether erroneous legal standards were employed in holding that the fair market value of old houses taken in trade when selling new houses were at least equal to the existing encumbrances on these old trade-in houses plus the trade-in-allowances made on these old, trade-in-houses, thus taxing taxpayer (a homebuilder) a large amount on unrealizable "paper" profits.

STATUTES INVOLVED

The following statutory provisions are set forth in Appendix C, infra, pp. 33-35, Sections 1001 (a), (b), and (c), 1002, 1011, and 1012 of the Internal Revenue Code of 1954.

STATEMENT

In the tax years involved (1955-1958) Petitioner, Post Oak Manor Building Company, Inc., hereinafter called Building Company), was a wholly owned Texas Corporate Subsidiary of Petitioner, Willow Terrace Development Co., Inc., a Texas Corporation, and filed consolidated income tax returns with the latter said corporation.

In these said tax years Building Company built and sold new houses in the Post Oak Manor Subdivision in Harris County, Texas. In making sales of new houses, Building Company, without ever inspecting the old houses involved, often accepted in trade the interest or equities of the new house purchasers in old houses as a part of the sales prices of new houses. The said old houses accepted in trade all had prior, existing, outstanding mortgages owing on them. The interest or equities in these old houses, or "trade-in-allowances", were treated as part of the down payment on the new houses sold. During the tax years involved, 151 separate transactions were made involving 151 old, trade-in-houses and total "trade-in-allowances" of $348,609.73, as thus described, were made.

For business reasons (to avoid showing any contingent liability of Building Company for the outstanding indebtedness against the trade-in-houses on its financial statement, and to prevent it from becoming involved in foreclosures to the displeasure of the Federal Housing Administration) Building Company had the new house purchasers deed these old, trade-in houses to Terwil Corporation, a corporation owned by the same stockholders who owned the petitioner corporation. The equities in trade-in houses were given a zero basis for Federal income tax purposes by Terwil Corporation and Terwil paid federal income taxes as money was received on these houses. Building Company regarded the transfer to Terwil Corporation as a sale from Building Company to Terwil Corporation but the Courts below have not agreed with this determination given to the transaction.

Terwil Corporation sold the interest, or equities, it had thus acquired in the 151 old, trade-in houses in the best

manner possible for the most cash that could be realized in any fashion (R. 46-48, 51). They were sold under contract for deed, with a down payment of $200.00, usually, with the balance of the purchase price (of the equity) to be paid *after* the existing mortgage or mortgages on the old trade-in houses were fully paid. The balance due on these contracts was slightly in excess of the "trade-in-allowances". As held by both courts below, there was no market for the contracts thus received by Terwil Corporation on the trade-in houses.

The total down payments received under the said contracts for deed on the 151 old, trade-in houses were $34,-200.00 but when actual sales expenses were deducted from this amount, the net amount of cash received was only $9,345.13. The president of Terwil Corporation was paid no salary. Sixty per cent of the stock of Terwil Corporation was sold for cash on May 8, 1958 (the last tax year in question) at a price that would produce $8,000.00 if all of the stock has been thus sold.

The commissioner determined that the entire amount of the said trade-in-allowances ($348,609.73) should be included in Building Company's gross income as part of the amount realized from the sale of new houses under the Internal Code of 1954, Section (1001 (a) and (b)).

At the trial of the cause in the Tax Court, Petitioners produced three witnesses who each testified as to the fair market value of all of the 151 old, trade-in houses except two (which were located out of the city of Houston where the others were located). The Commissioner at said trial produced two witnesses who each separately testified as to the gross fair market value of only 12 of the old, trade-in

houses, (being both a total of only 24 of the old, trade-in houses) without taking into account the large expenses involved in the sale of the trade-in houses under their methods of appraisal. Commissioner's witnesses gave no testimony on 127 of these trade-in houses.

Neither of the two courts below, nor the commissioners two witnesses in their testimony on a total of only 24 of the 151 old, trade-in houses, took the following factors into account:

1. The old, trade-in houses were already subject to an existing, prior mortgage or mortgages. (R. 274-275, 280, 290, 291).

2. The commissioners appraisers appraised the old, trade-in houses as if a new loan would be procured in selling these old, used trade-in houses. However, refinancing and brokerage (necessary to refinance to realize cash) sales commissions, closing costs, making of monthly maturing mortgage payments, taxes, insurance, etc. until resale, and repairing the old, trade-in houses in order to prepare them for resale by a new loan that would pay off the existing loan were not taken into account by the commissioners appraisers. (R. 280-281, 290-292). On a typical trade-in house in the years at bar these expenses would have been more than $2000.00 for each old, trade-in house. (R. 46-48).

3. The same down payments were required on both new houses and old, used houses in all of the years at bar when financing was insured by the Federal Housing Administration.

The tax court below determined that the Building Company was taxable on the entire amount of the said trade-in-allowances ($348,609.73) that it made in the transactions whereby it received old, trade-in houses and held that their fair market value was "at least equal to the total of the outstanding encumbrances and the owners equities in the trade-in houses". The United States Court of Appeals for the Fifth Circuit has affirmed this determination.

REASONS FOR GRANTING THE WRIT

The basic question presented involves whether erroneous legal standards may be used in the tax court of the United States in determining "fair market values" of trade-in houses to be the amount of the trade-in allowances where old, used, trade-in houses with indebtednesses already owing on them are received by a seller in trade. The net result of the decision below allows the trade-in-allowances to represent this fair market value, without determining this fair market value, and without regard for resale costs.

All evidence to the contrary was disregarded even though this evidence was not refuted in 125 instances (of the 151 trade-in houses the commissioner produced evidence on only 24 and the petitioners did not produce appraisals on two houses located outside of the city of Houston). The stated amount of uncertain contracts of long duration obtained on resale, on which there were no principal payments until the first mortgage was repaid and which were held not marketable by both lower courts, were used as a legal standard to support the lower decisions. This treatment and result is contrary to this Honorable Court's decision in *Burnet v. Logan,* 283 U.S. 404, 51 S.Ct. 550; 2nd Cir., 42 F.2d 193.

THE QUESTION IS SUBSTANTIAL AND OF VITAL INTEREST TO THE NATION-WIDE HOUSING INDUSTRY AND OUR NATIONAL ECONOMY

In today's housing market, home builders are forced to accept old, trade-in houses with mortgages already owing on them as a means of selling new houses. Most often, as here, the interest or the equity thus received, subject as it is to existing mortgage indebtedness, cannot be converted to any medium of a marketable asset that will produce enough cash to pay even a small amount of the expense of resale alone, much less an unrealistic income tax produced on the amount allowed in trade.

This cause is so important to the economy of our nation and the decision of the Tax Court (affirmed by the United States Court of Appeals for the 5th Circuit) is so contrary to existing court decisions that the NATIONAL ASSOCIATION OF HOME BUILDERS (Washington D. C.) filed an Amicus Curiae brief in the United States Court of Appeals for the 5th Circuit stating:

> "The National Association of Home Builders views the decision of the Tax Court with considerable concern, and fears that, unless standards of valuatoin are enunciated which require a realistic determination of fair market value of trade-in houses, a severe depressant on home building operations across the nation will result."

The alarm of the National Association of Home Builders is amply justified, as emphasized by the Research Institute of America, a prominent National Tax Publication, when in reference to this cause it stated:

". . .the building company gave total trade-in allowances of $349,000, but received only $9,000 in cash, after paying selling expenses on the old houses. The company claimed that its sales income from trade-ins should include, at most, not more than $8,000 to $12,000. . . But the Treasury taxed the full $349,000 as income. . .

Observation: The builder here had to pay $170,000 in income tax though it received only $9,000 in cash. . . from selling the trade-in property.

Observation: Automobile dealers, etc., who accept trade-ins don't have too much of a problem because their old cars are generally sold strictly for cash or its equivalent through refinancing. "(Tax Co-ordinator - Biweekly Alert, Research Institute of America, Vol. II, No .23, June 10, 1965.)

A valuation of 100% of the amount allowed in trade on trade-in houses has previously been unheard of as is evidenced by the fact that agents of the Commissioner initially set the fair market value of the trade-in house equities in this cause at 30% of the amount allowed in trade and this position was not changed until a rebuff had been received by the Commissioner's agents in the matters involved. (R. 230-235.).

There are few decisions on analogous situations, and the basic underlying problems thus presented, involving the Internal Revenue Code, have never before been squarely presented to the Courts for decision. The long existing trading practices in the automobile industry are similar. However, used automobiles are usually resold rapidly so that problems of large trade-in-allowances thus created eliminate themselves through the subsequent, rapidly realized resale losses. Because of fundamental differences, an old-trade-in house with a mortgage already owing on it is usually difficult ra-

ther than rapid in resale and the expense incident to the resale (especially one where the seller attempts to realize cash or a cash value) may be staggering. Thus, the economic benefits of an old, trade-in house, are insignificant because of continuing monthly mortgage payments, repair costs, discounts required of a seller to obtain a loan to finance the new purchaser, commissions, etc. Economically the most cash that can be realized is through a resale with a small down payment ($200 in most instances here, less commissions, etc.) and taking a contract for deed (providing payment of principal only when the prior mortgage is paid), which has no market value. However, under the decisions of the courts below, the resulting income tax would bankrupt the home builder and destroy business and industry.

The Internal Revenue Code has long provided, substantially as set forth in Internal Revenue Code, Section 1001, as follows:

(a) The gain from sale "shall be the excess of the amount realized therefrom over the adjusted basis provided. . .

(b) The amount realized from the sale. . .shall be the sum of any money received plus the fair market value of the property (other than money) rereceived." (Emphasis supplied.)

This court and others before have long held that a taxable gain results in a sale where other property is received under Section 1001 of the Internal Revenue Code only when the property has an established or fair market value and is equivalent to cash. In other words the fair market value is the actual cash value.

In *Logan v. Commissioner*, 42 F2 193, 195 and 196 (2nd Cir., 1930), affirmed by this Honorable Court in 283 U. S. 404, 51 S.Ct. 550, the court had to determine, under Internal Revenue Code provisions substantially identical to those existing in this cause, the profit on a sale of stock for part cash and part being a contract to pay 60 cents per ton for iron ore and stated:

> ". . .income is declared and taxes imposed when cash is paid in a sale or where the thing received is capable of easy evaluation *in cash* . . .where the consideration received is found to be the *equivalent of cash,* it may be valued and . . . taxed . . . it must have an established or fair market value; it *must be the equivalent of cash.* . .
>
> The Commisioner may not create income by spelling out paper profits with all the attending uncertainties which exist here and which might prevent the return of capital." (Emphasis supplied)
>
> In affirming this case this honorable Court stated:
>
> "The promise was in no proper sense the *equivalent of cash.*" (Emphasis supplied.) *Burnet V. Logan,* Supra.

Again the 2nd Circuit in *Andrews v. Commissioner,* 135 F2 314, 317 (2nd Cir., 1943), in speaking of the "fair market value" of scrip, which had been received by taxpayers, described it as "what-you-could-have-got-for-it-in-money-if-you-had-sold-it".

See also *Stiles V. Commissioner,* 69 F2 951, 952 (5th Cir., 1934) and 47 CJS 328, Section 191 (Exchange of Property).

Refinancing of the old, trade-in houses received in trade in order to receive cash and so as to dispose of the already existing mortgages owing on them, was not feasible. Petitioners unrefuted witness testified: (1) refinancing was not possible because of discounts in connection with placing a new loan on the property for the purchaser, real estate commissions, repair costs and closing costs would amount to more than $2000 per trade-in house. (Cash realized on all trade-in houses would have been less than the $9,345.13 realized by the method of selling that were utilized) (2) sale of these trade-in houses under a contract for sale (as was accomplished by Terwil Corporation) was the best method of disposing of these trade-in houses; and (3) no more cash could have been received in any fashion than from the sales that were consumated through Terwil Corporation, which sales produced a net cash amount of $9,345.13 (R. 46-48, 51). Yet the Commissioner's two witnesses in testifying as to a total of only 24 of the 151 trade-in houses did not take into account that the trade-in houses had mortgages already owing on them and that to realize the gross sums that his witnesses testified to would require refinancing and expense. (R. 280-281, 290-293.)

Hence, the old, trade-in houses were sold by Terwil Corporation in the best fashion possible for the most cash that could be realized. The fact that the net amount of cash realized on these sales was only $9,345.13 and that there was no established market for the remaining contractual stated amounts, which Terwil Corporation received in addition to the cash down payment, is indicative of their value. The value of the contracts are further supported by the findings of the Tax Court that 60% of the stock of Terwil Corporation sold for $4,800.00 (or $8,000.00 for 100% of such stock) on May 8, 1958, the last tax year in question. (R. 55, 426.)

The gross amount of these contracts for sale of the old, trade-in houses held by Terwil Corporation had no bearing and is no support at all for the fair market value of the trade-in houses, since the Tax Court found there was no market for these contracts.

It is the taxing of the gross amount of such unmarketable items that this court condemned in *Burnet V. Logan,* Supra. As indicated in the previous words of Judge Learned Hand in speaking of contracts, these contracts for the sale of the old, trade-in houses which were restricted in their marketability, as found by the courts below, were undoubtedly affected by an untenable merchandising problem in their sale, ". . . if at all, only by seeking out a purchaser and higgling with him . . ." See *Bedell v. Commissioner,* 30 F2 622, 624, (2nd Cir., 1929)

The taxpayers recognize here, as they did at the trial, that the burden was upon them to establish that the values of the trade-in houses were below those asserted by the Commissioner. However, this burden was unquestionably met, at least from the standpoint of establishing a prima facie case, by the testimony of three competent and experienced witnesses who had appraised 149 of the houses concerned. This testimony showed that the fair market value of these 149 houses on the dates they were received was no more than the amounts of the outstanding encumbrances. Had this evidence constituted the sole proof on this point, the presumption favoring the Commissioner's determination of larger values for such 149 houses would certainly have disappeared. See *Estate of Albert Rand,* 28 T. C. 1002 (1957).

There was, however, evidence of (1) subsequent sales of trade-in houses and (2) testimony concerning appraisals

made of 24 of the 151 trade-in houses by Government witnesses. This was the evidence credited by the Tax Court.

As to the first, proof of the subsequent sales, the Tax Court plainly applied improper legal standards contrary to this Court's *Burnet v. Logan*, Supra, and other cases, and as further set forth above. How could contracts for which there was no market, as held by both courts below, form any logical nucleus for the conclusion that the full amount of "trade-in allowances" should properly be taxed?

As to the second, testimony concerning 24 appraisals out of 151 trade-in houses, the only other evidence as to the fair market value of 125 of these 151 trade-in houses was that of the Petitioners. (2 houses located out of Houston were not appraised for Petitioners.) Reliance on the commissioners appraisal evidence on only 24 of the 151 trade-in houses by the United States Court of Appeals in its opinion as "the long and the short of the matter" and as "adequate . . . to carry the day . . ." was also fundamental error.

The Tax Court finding in reliance on these 24 appraisals was at most a summary one. The Tax Court made no specific findings of fact as to these appraisals. See findings of fact R. 453-474. In its opinion the Tax Court in a one sentence paragraph simply referred to the appraisals as "amply" showing the value of the trade-in houses to be "at least equal to" the outstanding encumbrances and equities (R. 482).

While a sampling of the old, trade-in houses might be some indication of value as to the 24 trade-in houses appraised, it could not support the specific house by house factual finding as to the 127 trade-in houses that was not appraised. Cf. *Anderson v. Commissioner*, 250 F2 242, 246

5th Cir., 1957.) Houses are not fungible goods. Houses are individual. The fact that the remedy of specific performance is customarily available in a residential contract of sale is also legal recognition of this individuality.

Even as to the 24 appraisals made by the Commissioner's two witnesses, no expenses of sale were considered in these appraisals. (R. 280-282; 290-291.) In the only other similar case involving income taxation, expenses of repairs have been recognized in arriving at the fair market value of used automobiles taken in trade. *Lord Motor Co. v. Commissioner,* 5 B.T.A. 818, 820.

In the case at bar, as set forth above, these expenses of sale in a situation such as the commissioners witnesses have attempted to appraise, would amount to more than $2,000.00 per house on the 151 trade-in houses, or a total of $302,000.00, without taking into account regularly maturing monthly mortgage payments. This large amount alone (without taking into account monthly mortgage payments) would eliminate most of the $348,609.73 determined by the commissioner and affirmed by the courts below, as the proported fair market value of the trade-in houses.

Relying on these improper standards, it may be that the best the Tax Court could do was to find a value "at least equal to" encumbrances plus equities. The predicate of valueless contracts and inadequate appraisals was a difficult base from which to reach a finding of specific values for the houses. But nevertheless these taxpayers were entitled to have such a finding. Not only gain on the trade-in houses but subsequent taxable income will be dependent on the tax basis of each house. The duty of the Tax Court was to

find a specific value for the trade-in houses, not a value "at least equal to" or a value not "less than" encumbrances plus equities. Precisely this finding was condemned in *Gersten v. Commissioner*, 267 F2 195, at 198-199 (9th Cir., 1959).

If such economic realities are not recognized in the housing industry, where a sale cannot quickly eliminate the loss or where sale is deferred or defeated, as here, our industry, our national economy and our civilization will be destroyed. Economic realities must be realized in formulating and applying the laws of taxation. See *Compania General de Tabacos de Filipinas v. Collector*, 275 U. S. 87,100; 48 S. Ct. 100, 105; *Texas Trailer Coach Company v. Commissioner*, 251 F2 395, 403 (5th Cir., 1958); *Nelson Weaver Realty Company v. Commissioner*, 307 F2 897, 901 (5th Cir., 1962.).

Fundamentally erroneous theories of valuation have previously been condemed by this and other courts. See *Helvering v. Taylor*, 293 U. S. 507; 55 S. Ct. 289, 287; 79 L Ed. 623; *Champion v. Commissioner*, 303 F2 887, 892-893 (5th Cir., 1962).

Finding that the petitioners have not overcome the presumption of correctness is one thing. However, determining that the Tax Court has properly proceeded when (1) fair market value has not been determined; (2) unmarketable contracts have been used to determine fair market values; (3) no evidence was offered for the commissioner on 125 individual trade-in houses; (4) evidence offered by petitioners on these 125 houses and all but two of the other trade-in house was ignored; (5) enormous cost of sale, even in connection with the 24 appraisals offered by the com-

missioner, were not considered; and (6) economic realties have been ignored, so conflicts with the decisions of this court, and other courts, and so further violates the legal standards required of any court as to totally permeate with fundamental error the matters here adjudicated below.

CONCLUSION

For the reasons stated, the question presented by this appeal is substantial; has been decided contrary to the decisions of this court; has been decided contrary to the decisions of other circuit courts; and is of Nation-Wide and public importance. It is respectfully submitted that probable jurisdiction should be noted.

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APPENDIX "A"

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

NO. 21,241

WILLOW TERRACE DEVELOPMENT CO., INC. and POST OAK MANOR BUILDING CO., INC.,
Petitioners-Respondents,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.
(AND REVERSE TITLE)

Petition for Review of Decision of the Tax Court of the United States (District of Texas).

(June 1, 1965.)

Before GEWIN and BELL, Circuit Judges and McRAE, District Judge.

BELL, Circuit Judge: Taxpayers are the Willow Terrace Development Co., Inc., and its wholly-owned subsidiary, Post Oak Manor Building Co., Inc. Both corpora-

tions engaged in developing real estate subdivisions in the Houston area, and filed consolidated corporate income tax returns for the tax years here involved, 1955-1958. They petition to review a decision of the Tax Court requiring the Building Company to include in gross income the full amount of "trade-in allowances" given to purchasers of new homes in return for equities in their old homes. The Commissioner cross-petitions from the Tax Court's decision allowing the Building Company to add the cost of constructing water and sewerage facilities to the cost basis of the houses it built and sold. The opinion of the Tax Court is reported at 40 T.C. 689. We affirm on both questions.

I. The Taxpayers' Appeal

Building Company built and sold new houses in the Post Oak Manor Subdivision in Harris County, Texas. In making sales of new houses, the building company often accepted the purchaser's interest or equity in his old house as part of the sales price for the new house in Post Oak Manor. The credit received by the purchaser, or "trade-in allowance," was treated as part of the down payment on the new house. The trade-in houses all had outstanding mortgages on them, and Building Company acquired them subject to prior encumbrances. During the tax years here involved, Building Company made trade-in allowances on the equities in 151 houses in the total amount of $348,609.73.[1]

[1] The Tax Court stated:

"A typical transaction would be somewhat as follows: Building Co. would offer a new house in Post Oak Manor for sale for $16,000. Mortgage arrangements on this new house could be made for $13,000. A prospective purchaser had a house that cost him $10,000 but was subject to an encumbrance of $8,000. He could buy Building Co.'s $16,000 home by paying $1,000 cash, deeding his old home to Terwil (subject to the $8,000

Rather than taking title to the trade-in houses directly, Building Company had the new house purchasers deed them to Terwil Comporation, a corporation owned in the same proportions by the same three men who owned Development Company which in turn owned Building Company.[2] Terwil attempted to resell the houses as soon as possible to avoid making mortgage payments, and all 151 were sold under contracts for a deed, with a small down payment, usually $200, and with the balance of the purchase price to be paid after the existing mortgage was satisfied. Interest on the contract price was to be paid in the interim. The total face amount of the 151 contracts was approximately $392,600, but when sales expenses were deducted from the initial payments totaling $34,200, the net amount of cash received was only $9,345.13. The balance due on the contracts was $358,600. There was no established market in the Houston area for the contracts received by Terwil Corporation for the trade-in houses.

The Commissioner determined that the entire amount of the trade-in allowances ($348,609.73) should be included in Building Company's gross income as part of the amount realized from the sale of new houses under § 1001 (a), (b) of the Internal Revenue Code of 1954. That section provides that the "amount realized from the sale . . . of property shall be the sum of any money received plus the fair

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encumbrance) for which Building Co. would give him a $2,000 trade-in allowance, and making arrangements for a $13,000 mortgage on the new home to pay the balance of the $16,000 purchase price."

[2] This method was followed to avoid showing any contingent liability of Building Company for the outstanding indebtedness against the trade-in houses on its financial statement, and to prevent it from becoming involved in foreclosures to the displeasure of the Federal Housing Administration.

market value of the property (other than money) received." In the Tax Court Building Company contended that the fair market value of the trade-in houses was not equal to the trade-in allowances, but was zero, or in any event, not more than from $8,000 to $12,000. The Tax Court held that Building Company failed to sustain its burden of showing that the fair market value of the trade-in houses was less than $348,609.73. We agree.

The standard for determining fair market value under § 1001 is well established. It is the price at which property will change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts. *French Dry Cleaning Co. v. Commissioner,* 5 Cir., 1934, 72 F.2d 167. The Tax Court applied this standard. *Stiles v. Commissioner,* 5 Cir., 1934, 69 F.2d 951, relied on by taxpayers for their contention that the proper standard is the amount presently realizable in cash, is not to the contrary. Indeed, the court in the *French Dry Cleaning Co.* case so stated.

Given that the Tax Court applied the proper legal standard in determining fair market value, there was ample evidence to support its conclusion that the fair market value of the equities in the trade-in houses was at least equal to $348,609.73, the amount of the trade-in allowances. One factor considered by the Tax Court was what they were actually sold for in the open market, $293,600. The receipt of only slightly more than $9,000 net in cash after sales expenses does not alter the fact that the price at which Terwill sold the houses was substantially above the trade-in allowances. Moreover, and this is the long and short of the matter, the Commissioner introduced the testimony of two real estate appraisers which established a value for the

trade-in houses in excess of the trade-in allowances. Taxpayers' appraisers testified that the value of the houses was only $12,000, and there was other evidence to support the taxpayers' contention. However, the testimony of the Commissioner's witnesses was adequate, if credited as it was by the Tax Court, to carry the day for the Commissioner, and the finding by the Tax Court was in no event clearly erroneous. See *Greer v. Commissioner,* 5 Cir., 1964, 334 F.2.d 20.

Taxpayers argue alternatively that even if the trade-in houses were worth the trade-in allowances, Building Company sold the houses to Terwil Corporation at a corresponding loss. In this regard, the Tax Court was correct in holding that there was no sale by Building Company to Terwil. Form must give way to substance in the tax law. *Commissioner v. Court Holding Co.,* 1945, 324 U.S. 331, 655 S.Ct. 707, 89 L.Ed. 981; *Hindes v. United States,* 5 Cir., 1964, 326 F.2d 150.[3]

It follows that the decision of the Tax Court requiring Building Company to include the full amount of the trade-in allowances in gross income must be and it is affirmed.

II. The Commissioner's Appeal

Building Company constructed all houses in Post Oak Manor Subdivision in accordance with Federal Housing

[3] Building Company followed the bookkeeping practice with respect to the trade-in allowances of debiting an account called trade-in allowances for the amounts allowed, and then writing off these amounts at the end of the year as worthless. On its tax returns for the years in question it reported the allowances as sales receipts but deducted the amount thereof as expense. In the Tax Court they contended simply that they had overstated their new house sales to the extent of the allowances since the equities in the trade-in houses were without value.

Administration specifications and requirements in order to secure FHA or Veteran's Administration loan insurance guarantees on the mortgages to be utilized in the purchase of the new houses. As a condition to issuing loan commitments on the subdivision, the FHA required that a satisfactory water system and sewerage disposal system be made available to the new houses. Building Company first attempted to secure these facilities from the City of Houston. Post Oak Manor was at that time beyond the city limits, and Houston declined to construct the facilities. After determining that it would be more economical to construct and operate its own systems rather than obtain them from a neighboring subdivider, Building Company constructed a water plant, sewerage disposal plant, and the necessary connecting systems. The total cost of these facilities to Building Company was $157,187.49.

By an instrument dated July 30, 1954, Building Company transferred the water and sewerage facilities to Post Oak Manor Water Company, Inc., a separate corporation owned in identical proportions by the same three men who owned Development Company and Building Company. The only consideration furnished by the Water Company was its agreement to operate the systems. The transfer agreement set the rates which Water Company would charge, and provided that the rates could be increased only if they proved insufficient to cover operating costs, provide sufficient reserves for replacement, obsolescence and depreciation, and a reasonable rate of return on the basis of capital investment.

Pursuant to FHA requirements, Water Company executed a trust deed transferring title to the facilities to an approved trustee for the benefit of the property owners.

Water Compnay retained the active control and management of the systems, but the trust deed provided that if the Water Company abandoned the plant, changed the rate structure materially, or failed to provide satisfactory service, the trustee could take over the operation of the system for the benefit of the property owners.

Water Company carried the facilities on its books at a zero basis, and no depreciation was ever claimed on them. The president of the company received no salary. Without allowance for depreciation, the operations of the company from 1955 through 1959 produced net income for the five year period of $12,934.02.[4] Assuming a five per cent replacement factor per year on cost, the operation resulted in a net loss of $17,702.80.[5]

By an ordinance enacted on December 31, 1956, the city of Houston annexed an area which included the Post Oak Manor Subdivision. Action by the city to annex this area had been begun by at least the preceding February. By ordinance of May 1, 1957, the city prohibited private water companies in the annexed area from increasing their rates

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[4] The figures for each of the five years are as follows:

Net Income

1955 —	$ (216.45)	loss
1956 —	(2,877.60)	loss
1957 —	12,697.20	
1958 —	2,286.40	
1959 —	1,044.47	

[5] The corresponding annual figures are:

Net Income

1955 —	$(2,146.43)	loss
1956 —	(8,371.29)	loss
1957 —	5,202.79	
1958 —	(5,572.97)	loss
1959 —	(6,814.90)	loss

until futures rate hearings. Water Company sought permission to increase its rates but was refused. Negotiations for the sale of the facilities to the city were begun, and in September, 1959, the city of Houston purchased all of Water Company's water and sewerage facilities for $221,200. There were about 60 private water and sewerage systems in the area annexed in December, 1956, but by November 1962, the city had acquired only 40 of them. From 1950 to 1955, the city acquired 47 private systems that were located in an area annexed to the city in 1950.

Building Company sought to deduct the full $157,000 cost of the water and sewer systems as part of the cost basis of the lots it had developed. This was accomplished by allocating a pro rata portion of the $157,000 to the cost of each of the 432 lots in the subdivision. Under §§ 1012 and 1016 of the Internal Revenue Code, the proper basis for the lots is "cost" plus "adjustment . . . for expenditures . . . properly chargeable to capital account." The Commissioner disallowed the deductions in full, taking the position that the cost of the water and sewerage systems was not part of the cost of the lots, but was an independent investment in separate valuable property, the cost of which should be recovered through capitalization or subsequent sale. The Tax Court, relying on its prior decision in *Estate of Collins v. Commissioner*, 1958, 31 T.C. 238, sided with the taxpayers, and the Commissioner appeals.

The Commissioner's position is that the facilities may be allocated to the cost of the lots only if they are constructed in order to sell the lots and are permanently and irrevocably dedicated to the lot owners so that the cost of the facilities is recoverable in no other manner. Thus, streets, sidewalks, public parks and recreation areas in which the

developer retains no interest are properly considered part of the cost of the lots sold. See *Country Club Estates, Inc. v. Commissioner,* 22 T.C. 1283 (1954). However, the Commissioner contends that the water and sewerage systems here involved were a separate investment in valuable and potentially income producing property by the developer, which property was retained by the developer rather than dedicated to the homeowners. The cost of such an independent investment, according to the Commissioner, should be recovered through depreciation of the facilities or subsequent sale. Here the taxpayer did in fact recover the cost by selling the facilities to the City of Houston.

Estate of Collins v. Commissioner, supra, involved a sewerage disposal system. There the Tax Court stated the rule as follows:

> ". . . if a person engaged in the business of exploiting a real estate subdivision constructs a facility thereon for the basic purpose of inducing people to buy lots therein, the cost of such construction is properly a part of the cost basis of the lots, even though the subdivider retains tenuous rights without practical value to the facility constructed (such as a contingent reversion), but if the subdivider retains 'full ownership and control' of the facility and does 'not part with the property. . . for the benefit of the subdivision lots,' then the cost of such facility is not properly a part of the cost basis for the lots."

The opinions of the Tax Court in *Collins* and in this case are buttressed by the recent decision of the Fourth Circuit in *Commissioner v. Offutt,* 4 Cir., 1964, 336 F.2d 483. Taxpayer in that case was allowed to deduct the cost

of water and sewerage systems on facts very similar to those presented here. We agree with the Tax Court and with the Fourth Circuit.

The problem presented by these cases is whether deduction or capitalization of such costs will more accurately reflect the economic realities of the situation from the standpoint of the subdivider. We cannot accept the rule advocated by the Commissioner, which in effect allows deduction only when the costs can be recovered in no other manner. Some relevant factors to be considered in determining the proper tax treatment of the costs of such facilities are whether they were essential to the sale of the lots or houses, whether the purpose or intent of the subdivider in constructing them was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses, whether and the extent to which the facilities are dedicated to the homeowners, what rights and of what value are retained by the subdivider, and the likelihood of recovery of the costs through subsequent sale. These factors were considered in *Collins*, and the holding centered on the basic purpose test as modified by ownership. The Tax Court said:

> ". . .We have concluded that petitioners constructed the sewerage system not only for the basic purpose but for the sole purpose of inducing and making possible the sale of lots. . ., that they did not retain full ownership and control of the sewerage system, and that they parted with material property rights therein for the benefit of the subdivision lots."

In the present case the facts meet this test and support the conclusion of the Tax Court. The basic purpose of

Building Company in constructing the facilities was to sell lots and houses, not to invest in the water and sewerage business. It was essential that the lots in the subdivision be supplied with water and sewerage, both in order to sell the lots and in order to secure FHA financing. Building Company constructed the facilities itself only after the City of Houston refused and after it was determined that to secure them from a neighboring subdivider would be more expensive.

The water and sewerage systems were, under the FHA trust deed, dedicated to the benefit of the lot owners. Legal title was held by the trustee for their benefit. Abandonment, impairment of service or any material increase in rates would give the trustee the right to take over the facilities. Water Company retained only the right and duty to operate the system. There is no indication that the developers of Post Oak Manor anticipated any independent profit from the operations of Water Company, and, allowing for replacement costs, no profit was in fact made. At the time of the trust deed, the assests in the hands of Water Company had little if any saleable value. Sale to the City of Houston became possible only after the Post Oak Manor area was annexed to the city. The possibility of future sale to the city must be considered remote at that time, depending as it did on the vagaries of future annexation.

In sum construction of the water and sewerage systems was necessary, if not, essential, to the sale of homes in Post Oak Manor, and the systems were in fact constructed for that purpose, as distinguished from the purpose of independent investment. The facilities were dedicated to the benefit of the homeowners under the FHA trust deed, the rights retained by Water Company having at that time

little if any saleable value, and the possibility of recovering the costs through future sale to the city was remote. The conclusion of the Tax Court that the cost of these facilities were properly allocated to the cost of the houses sold by Building Company rested on these conclusions of fact which find support in the record. Its decision was correct, and it is thus AFFIRMED.

AFFIRMED on the petition and cross-petition.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1964

NO. 21,241

D. C. Docket No. 89852-Civil

WILLOW TERRACE DEVELOPMENT CO., INC. and POST OAK MANOR BUILDING CO., INC.,
Petitioners-Respondents,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.

(AND REVERSE TITLE)

Petitions for Review of Decision of the Tax Court of the United States (District of Texas).

Before GEWIN and BELL, Circuit Judges and McRAE, District Judge.

JUDGMENT

This cause came on to be heard on the petitions of Willow Terrace Development Co., Inc. and Post Oak Manor Building Co., Inc., and Commissioner of Internal Revenue, for review of decisions of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the de-

cisions of the Tax Court in this cause be, and the same are hereby affirmed.

June 1, 1965

Issued as Mandate:

APPENDIX "B"

[243] - Bell

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 21,241

WILLOW TERRACE DEVELOPMENT CO., INC. and POST OAK MANOR BUILDING CO., INC.,
Petitioners-Respondents,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.

(AND REVERSE TITLE)

Petitions for Review of a Decision of the Tax Court of the United States (District of Texas).

(Filed July 1, 1965)

ON PETITION FOR REHEARING (July 1, 1965)

Before GEWIN and BELL, Circuit Judges and McRAE, District Judge. PER CURIAM:

It is ORDERED that the petition for rehearing in the above entitled and numbered cause be, and the same is, hereby DENIED.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 21,241

WILLOW TERRACE DEVELOPMENT CO., INC. and POST OAK MANOR BUILDING CO., INC.,
Petitioner-Respondent,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.

(AND REVERSE TITLE)

Petitions for Review of Decision of the Tax Court of the United States (District of Texas).

(Filed July 22, 1965)

Before GEWIN and BELL, Circuit Judges and McRAE, District Judge. BY THE COURT:

IT IS ORDERED that the request of National Association of Home Builders for leave to file brief Amicus Curiae be, and the same is hereby GRANTED.

IT IS FURTHER ORDERED that the Motion for Reconsideration of Petition for Rehearing filed on behalf of Petitioners-Respondents be, and the same is hereby DENIED.

APPENDIX "C"

INTERNAL REVENUE CODE SEC. 1001.

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

(a) COMPUTATION of GAIN or LOSS. — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into any account any amount reimbursement for real property taxes which are treated under section 164 (d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164 (d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) RECOGNITION of GAIN or LOSS.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

INTERNAL REVENUE CODE SEC. 1002. RECOGNITION OF GAIN OR LOSS

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

INTERNAL REVENUE CODE SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

INTERNAL REVENUE CODE SEC. 1012. BASIS OF PROPERTY—COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

CERTIFICATE OF SERVICE

I, ROBERT H. McCANNE, one of the Attorneys for WILLOW-TERRACE DEVELOPMENT CO., INC., and

POST OAK MANOR BUILDING CO., INC., Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify, depose and say that on 3rd day of September, 1965, I served copies of the foregoing Petition for a Writ of Certiorari to the United States Court of Appeals for the 5th Circuit, which said petition was filed in the Supreme Court of the United States, by serving the several parties thereto, as follows:

(1) On the United States by mailing a copy of said Petition in a duly addressed envelope with airmal postage prepaid to the Solicitor General, Department of Justice, Washington 25, D. C.

(2) By mailing a copy of said Petition, in a duly addressed envelope with airmail postage prepaid to the Honorable Louis F. Oberdorfer, Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C.

(3) By mailing a copy of said Petition, in a duly addressed envelope with airmail postage prepaid to the Honorable Crane C. Hauser, chief counsel, Internal Revenue Service, Washington, D. C.

(4) By mailing a copy of said Petition, in a duly addressed envelope with airmail postage prepaid to the Honorable Sheldon S. Cohen, Commissioner of Internal Revenue (formerly U. S. Department of Justice—Internal Revenue Service—Treasury Department), Washington, D. C.

_____

Robert H. McCanne

Subscribed and sworn to before me at _____ this _____ day of _____, 1965.

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Notary Public in and for
Harris County, Texas